The Banking Sector and Its Regulation in the Czech Republic
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Ladies and gentlemen, I am honoured to have the opportunity to give a presentation here on the Czech experience with the building of financial regulation during the ten years of economic transition. As I am a representative of the Czech National Bank, which is responsible for the regulation of commercial banks only, I will concentrate on the banking system. Before going to the regulatory framework itself, let me give a short overview of the general situation in Czech banks.

I. The Czech Banking Sector – an Overview
In terms of its size relative to GDP, the Czech banking sector is probably the most developed one in Central and Eastern Europe. As figure 1 shows, bank credit to the private sector is just below 60% of GDP in the Czech Republic, compared with around 20% in Hungary and Poland or less than 40% in Slovenia. This puts the Czech Republic on a par even with some advanced market economies (e.g. Italy). This is due to the historically high reliance on bank intermediation in the Czech Republic, as well as to the fact that the Czech Republic – unlike many other transition countries – did not go through a period of high inflation that would have eroded the real value of banks’ assets and liabilities.

As a result, the Czech banking sector has a great potential, but at the same time the economy is susceptible to relatively major problems if the sector gets into distress – which has been the case in recent years.

Figure 1: The Scope of Bank Intermediation – an International Comparison
Figure 2 shows the year-on-year growth rates of bank credit in the Czech Republic (adjusted for the influence of balance-sheet clean-up operations), in both nominal and real terms. We can see that credit growth has slowed down substantially since mid-1998, and became negative in real terms during last year.

**Figure 2: Credit Growth in the Czech Republic**

![Chart showing credit growth in the Czech Republic](chart.png)

Source: Czech National Bank

There has been a lively policy debate about whether this has been due to problems on the supply side of the credit market (i.e. a “credit crunch”), or to problems on the demand side. These two explanations, however, are not strict alternatives, but rather complement each other. While we believe that the lack of profitable investment projects is the main explanation, it is becoming clear with the ongoing economic recovery and improving financial situation of industrial companies that the nominal stagnation in credit volume is associated with problems in the banking sector, too. In particular, the troubled large banks are suffering from a contraction in credit, while other segments of the banking sector have been achieving credit growth, although not strong enough to fully offset the former.

The indicator that probably reveals the extent of the problems in the Czech banking sector most clearly is the ratio of classified loans to total bank credit (see Figure 3). In 1999, this ratio increased by more than 5 percentage points and exceeded 32%. The problem has been most serious in large banks (with more than 40% of their loans being classified at the end of 1999) and small Czech-owned banks (more than 50% of their loans classified).
In risk-weighted terms, classified loans exceeded 15% of the total in 1999. Even though more than 80% of the implied losses are covered by reserves and provisions, and the rest is collateralised, the bad loan problem certainly represents a serious weakness in the banking sector.

**Figure 3: Classified Loans**

![Bar chart showing classified loans as a percentage of total credit from 1997 to 2000:Q3.](image)

*Source: Czech National Bank*

This, together with a desire to finish bank privatisation quickly, was why the government engaged in extensive clean-ups of the banks’ balance sheets. So far, the public costs of the banking sector transformation have been estimated at over CZK 250 billion, or 14% of yearly GDP (plus the as yet unknown public costs of the IPB case). Thanks to these clean-ups, the ratio of classified loans has started falling during 2000 (see Figure 3). But it is still quite high, and no real improvement has been visible so far, apart from the direct positive impacts of the clean-up operations.

Of course, the bad loan problem has very strongly affected the net profitability of the banking sector. The basic financial indicators of the Czech banking sector are summarised in Table 1. This table shows that the banks’ performance has been relatively satisfactory in terms of their operating profits. Even though net operating income has fallen down recently owing to a decrease in the interest rate spread (resulting from increased competition between banks), operating costs have decreased somewhat as well. Moreover, these costs are likely to fall further in the future thanks to a drop in the banking workforce, a process which has intensified during 2000.
On the other hand, the performance of the Czech banking sector in terms of net profits (measured by the ROA and ROE indicators – see Table 1) has been very poor, owing to the bad loan problem. It is important to stress, though, that the losses have been covered by the creation of additional reserves and provisions and by injections of fresh capital into the banking sector. As a result, the capital adequacy ratio has not only stayed above the 8% Basel minimum, but has actually increased to more than 16% this year.

Table 1: Czech Banking sector – Basic Financial Indicators

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<tr>
<td>Capital adequacy</td>
<td>9.47</td>
<td>12.06</td>
<td>13.64</td>
<td>14.07</td>
<td>16.65</td>
<td>16.83</td>
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<td>Operating income / assets</td>
<td>4.55</td>
<td>4.53</td>
<td>3.90</td>
<td>3.43</td>
<td>3.30</td>
<td>3.31</td>
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<td>Operating costs / assets</td>
<td>2.21</td>
<td>2.25</td>
<td>2.21</td>
<td>1.96</td>
<td>2.12</td>
<td>2.11</td>
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<td>ROA</td>
<td>-0.17</td>
<td>-0.39</td>
<td>-0.24</td>
<td>0.42</td>
<td>0.35</td>
<td>0.42</td>
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<tr>
<td>ROE</td>
<td>-2.88</td>
<td>-17.86</td>
<td>-4.29</td>
<td>7.48</td>
<td>6.56</td>
<td>7.76</td>
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<tr>
<td>Interest rate spread</td>
<td>3.76</td>
<td>3.52</td>
<td>2.63</td>
<td>2.40</td>
<td>2.49</td>
<td>2.54</td>
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<tr>
<td>Number of employees</td>
<td>51351</td>
<td>51935</td>
<td>48955</td>
<td>48732</td>
<td>48193</td>
<td>45661</td>
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<tr>
<td>Operating income / empl.*</td>
<td>1702</td>
<td>1865</td>
<td>1845</td>
<td>1652</td>
<td>1615</td>
<td>1725</td>
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Source: Czech National Bank;  
* CZK thousand per employee

The problems in the Czech banking and enterprise sectors have led to a redirecting of the financial flows in the economy. Before the economic recession started and domestic credit growth slowed down, the scheme of financial intermediation was in line with the expected standard for a transition economy (see Figure 4). Domestic savings were channelled into the enterprise sector primarily through domestic banks. The domestic resources were supplemented by a massive inflow of foreign debt finance, either directly to Czech companies or via Czech banks (this inflow altogether reaching almost CZK 200 billion, or 15% of yearly GDP, in 1994-95). The supply of liquidity to companies was thus more than sufficient. A major source of problems, however, was the inefficient assessment of credit projects and weak legal framework that later on contributed to the increase in non-performing loans. (Another problem was the instability of short-term foreign capital inflows, which have reversed since 1996).

Figure 4: Directions of Financial Intermediation in 1994-95

A: CZK 105 billion in 94-95; B: CZK 95 billion in 94-95
When the domestic credit channel became “blocked” (this term is probably not wholly accurate, as the problems concern only the segment of large banks and not the banking sector as a whole), it became one of financial constraints on the economic recovery. In a standard market economy, the problem would probably be partly overcome through disintermediation, i.e. through a greater reliance on the capital markets. In the Czech Republic, however, the capital markets are still underdeveloped (for historical reasons and because of a lack of market regulations in the recent past and a weak legal framework). As a result, this channel was not able to substitute for bank credits to any large extent (see Figure 5).

Over the course of time, however, the economy has found another way to substitute for domestic credit. The inflow of foreign direct investment has reached massive proportions since 1998. Foreign investors with experience in the relevant business have the capacity to assess the viability of domestic companies and, by obtaining controlling stakes in them, avoid the problem of poor enforcement of credit contracts. They thus can overcome the major reasons “blocking” the domestic credit channel. Foreign investors either use their own resources to finance the investments, or obtain credit from foreign or Czech banks. The foreign banks, in turn, often obtain – either directly or indirectly – financial resources from the Czech commercial banks with excessive liquidity, which they partly place abroad. The current scheme of financial flows thus looks as illustrated in Figure 5. It is hard to quantify the size of these flows, but Figure 5 provides at least some rough numbers from the Czech balance of payments.

**Figure 5: Directions of Financial Flows in 1998-2000**

A: CZK 45 billion; B: CZK 86 billion; C+D: more than CZK 130 billion (+ portfolio investment abroad); E: CZK 375 billion (of which 20%-40% physical investment)
As a result, the Czech National Bank has not considered the stagnation of domestic credit to be a serious obstacle to the economic recovery so far. The liquidity in the economy has been growing at a sufficient speed, which can be clearly seen if we contrast money supply growth with credit growth – see Figure 6 (although it is true that we have recently observed a downward tendency in the rate of money supply growth, too). Moreover, the growth of money held by the corporate sector has reached almost 15% year-on-year, or more than 10% in real terms. The financial indicators of industrial companies also show that the liquidity of firms has been improving rapidly.

![Figure 6: Money Supply Growth vs. Credit Growth](image)

Source: Czech National Bank

However, the non-functioning banking sector is certainly causing high transactions costs and structural problems that are negatively influencing the growth potential of the Czech economy (although the FDI inflow that is partly substituting for the credit channel is a factor which can increase the potential growth). The reform of the banking system thus needs to be completed if the economy is to increase its long-run growth and start to converge towards the EU.

**II. Bank Regulation**

Now let me proceed to the CNB’s regulatory role. As I mentioned at the beginning of my presentation, the CNB is responsible for the regulation of the banking system only. Besides the CNB, there are three other central institutions that participate in the regulation of the financial sector. There is a special office for overseeing saving and credit co-operatives (It is necessary to stress, that compared to the banking sector the role of co-operatives has been always marginal.). Regulation of other non-bank financial institutions is carried out
partly by the Ministry of Finance and partly by the Securities Commission (see Figure 7). Therefore, I concentrate on the regulation of one particular financial sector only, i.e. the banking sector, in my presentation today.

**Figure 7: Financial Regulators in the Czech Republic**

![Financial Regulators Diagram]

As we have seen, this sector has been going through substantial difficulties in recent years. One may ask, of course, to what extent this is the result of improper regulation by the CNB.

I believe it would be inappropriate to judge the supervisor’s performance in isolation from the historical context. Figure 8 shows the development of the banking sector as measured by the number of licensed commercial banks. It also divides the period since 1990 into three stages of development of the regulatory framework.

The supervisory department was established at the former SBCS in 1991, with only eight employees and an inadequate legal framework for its operation (at that time, the regulation of banks was primarily the responsibility of the Ministry of Finance – unlike at present). Banking supervisory operations were started in this department in the course of 1991, but much of its capacity was then taken up with the creation and implementation of new laws and central bank regulations. The controls that were carried out were aimed primarily at obtaining experience with this activity. The actual supervision of banks started to become more effective only during 1993, which can be considered the end of the early stage of bank regulation in the Czech Republic (the first conservatorship was introduced in 1993). It was during this early stage, however, that a massive expansion in the number of banks took place (see Figure 8). The progress in bank regulation thus lagged behind the progress in the banking sector itself. The banking sector had been in essence formed at a time when banking supervision was defined and conceived but when no supervisory activities had been developed. This contributed to some of the problems in the sector later on. But we can hardly put the major blame on the CNB’s regulatory department, as there were objective historical reasons for its gradual take-off.
Bank regulation became fully developed between 1994 and 1997. The year 1994 brought major organisational and legislative changes, which were a turning point for banking supervision. Supervisors now focused more on auditing and investigating banks’ activities. The number of banks stopped growing that year. In 1995, the knowledge acquired from supervisory activity began to be used to a greater extent in drafting and modifying prudential rules and there were increasing demands for banks’ shortcomings to be remedied. In 1996 and 1997 the Banking Supervision Group brought systematic pressure to bear for prudent conduct by banks. In view of the profound changes in part of the banking sector, this led to radical interventions in individual banks (see, for example, the number of unlicensed banks and banks under conservatorship in Figure 8), and to the formulation of a government programme to support the stability of the Czech banking system.

Since 1998, the major aim has been to stabilise the banking system and harmonize the regulatory framework with EU and international best practices. This effort has been based on a medium-term blueprint for the CNB’s banking supervision drawn up in January 1998. The focus of banking supervision has also shifted more towards comprehensive inspections targeted at banks’ risk management and internal audit systems.
The Czech regulatory framework has reached a high degree of harmonisation with international standards, and we are making a continuous effort to incorporate the recent trends in banking supervision into the system. In 2000, for example, the Czech National Bank participated in preparing amendments to the Act on the CNB and the Act on Banks that establish the legal basis for consolidated supervision of financial groups incorporating a commercial bank. Consolidated supervision will be gradually introduced between 2000 and 2002, when a regulation on capital adequacy on a consolidated basis will enter into force. The amendments to the basic banking laws also establish changes to the regulatory system that will become effective when the Czech Republic joins the EU and thus integrates its financial market into the single European market.

In April 2000, a CNB regulation on the capital adequacy of banks incorporating credit and market risks took effect (CNB Provision No. 3 of 28 June 1999 on the Capital Adequacy of Banks Incorporating Credit and Market Risks). This signifies a further qualitative step forward in measuring and managing bank risks. Specifically, each institution must adjust its risk-based capital ratio to take into account market risk (interest rate risk, exchange rate risk, equity risk and commodity risk) in its trading portfolio. The provision defines the trading and banking portfolios and the rules for determining the required level of capital. It contains the basic rules of the standard method for determining the capital requirements, in particular for determining both the general and the specific risk for the individual types of market risks and the level of the capital requirements for their coverage. It also defines the structure of the bank’s capital, the structure of risk-weighted assets in the banking portfolio and so on. It also includes a new calculation of credit exposure and its limits in relation to the bank’s capital and limits for open foreign exchange positions. The existing rules on capital adequacy, credit exposure and open foreign exchange positions have thus been merged into a single document. The new capital adequacy provision also enables banks to use their own models to calculate the individual risks from which the capital requirements are derived, provided they meet certain minimum requirements defined in this provision.

Needless to add, that the Czech legal and regulatory framework include all other standard elements, especially:
- standing requirements of application for banking licence
- prior consent from the CNB to acquire voting shares in a bank and the essentials of notification about decreasing a holding of voting shares in a bank
- loan classification and provisioning rules (modified in mid-1998 to take into account the weaknesses in the Czech legal and institutional framework);
- limits on loans to related parties (since 1994),
- information disclosure requirements; etc.
In 1994 the deposit protection scheme was established and in 1996 the anti-money laundering act came into force.

The actual oversight of banks has become quite effective, too. Of the 63 bank licences that were granted since 1989, 21 were revoked later on due to bad performance of the banks, and 1 bank (IPB) is now under conservatorship.

The supervision is based on two components: off-site surveillance and on-site examinations. Off-site surveillance chiefly involves regular evaluation of the positions of individual banks from the point of view of their observance of the prudential rules and their current financial situation. It also involves assessing all matters relating to the organisation of the bank, its shareholder structure, its management, its ownership links with other entities in both the financial and non-financial areas, external auditing and so on.

Since 1998, increasing emphasis has been put on examinations carried out on site. The aim of these is to determine the quality of the bank’s management systems, internal audit system, information systems and so on. Great attention is paid to checking the bank’s credit portfolio, as credit risk is currently the biggest risk in Czech banking. Inspection activities in banks are carried out in three forms. Comprehensive on-site examinations focus on all the bank’s areas of activity. Partial examinations are selected in cases where required on the basis of certain negative signals – obtained, for example, from off-site surveillance. The last type of examination is the information visit, which involves a discussion with the bank’s management about basic issues relating to the bank’s activities.

Important progress has been made with bank privatisation, too. After the sale of CSOB to KBC in 1999 and of CS to Erste Bank in 2000, the only bank that remains under state control (except for Konsolidacni banka) is KB, which will be privatised during 2001.

**III. Conclusion**

Privatisation, together with balance sheet clean-ups and well developed bank regulation, thus represent the key positive news giving rise to modest optimism about the future prospects of the Czech banking sector. I stress, however, that these measures are by themselves not sufficient to deliver a good result if the general legal and institutional framework of the economy does not function well and does not give sufficient protection to creditors. But even in this respect I am slightly optimistic. Many amendments to the existing laws have been drafted in recent years, and these should certainly bring some improvement. And I hope that the Government will remain determined to improving the legal framework in the future, as well.